



*Michael C. Schlachter, CFA
Managing Director and Principal*

December 1, 2008

Ms. Anne Stausboll
Interim Chief Investment Officer
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Asset Allocation Item (3b)

Dear Anne,

You requested Wilshire's opinion with respect to Staff's agenda item discussing the overall Asset Allocation and how to handle the violations of such ranges by some asset classes due to the recent market movements.

Recommendation

Wilshire recommends that the Investment Committee approve Staff's recommendation to temporarily expand the asset class ranges until the market environment, particularly the illiquidity in the fixed income market, allows Staff to rebalance to targets.

Wilshire hesitantly agrees with the recommendation to conduct a new asset allocation study in early 2009, for the reasons outlined below.

Discussion

Staff and your investment consultants explored a number of potential solutions to the issue facing CalPERS – the extreme market dislocation and the resulting violation of several asset class target ranges. We also consulted with several outside parties to seek any other advice that may be of use in this unprecedented situation.

After much discussion, we agreed that the best course of action is to allow the asset class allocation to exceed the target ranges in several asset classes until such time as the credit markets allow for sales / rebalancing at more realistic prices or the equity markets recover from their current lows. No other option, including buying stock options to hedge further market declines, selling fixed income at current prices, or reinvesting the 9% cash position in equity futures appeared to be a better use of CalPERS capital than waiting for

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action by the Federal Reserve and US Treasury to “free up” the currently illiquid fixed income markets.

Staff also recommends conducting a new asset allocation study in early 2009, and, as noted above, we reservedly agree with this recommendation. On the one hand, the recent market performance is not outside the realm of what was anticipated as “possible” in the fall of 2007 during the last asset allocation study. The performance of CalPERS’ portfolio is less than a two standard deviation event as defined by the assumptions used in the prior study. If the stock market and real estate market had increased in value 40% over the past year, no one would be requesting a new study, and so we believe that a market decline of similar magnitude should not drive the need for a new study.

We do note, however, that the illiquidity in the fixed income portfolio was unanticipated in the last study. In addition, the potential drain on cash liquidity that could be caused by commitments by AIM and Real Estate to new funds was also unanticipated.

As a result, the over-allocation to AIM, the inability to sell fixed income securities, and the potential need to maintain an on-going cash balance are all new elements of asset allocation that were not incorporated in the 2007 and argue for a new study. Therefore, we agree that such a study should be conducted.

Finally, however, we urge Staff and the Investment Committee to consider a wide variety of options for asset allocation. In the 2007 study, several members of the Investment Committee expressed concerns that the 18 asset allocation options were very similar and that little “true choice” was presented. In addition, the asset allocation study did not allow the Investment Committee to explore any “what if” scenarios but rather limited the members to the 18 pre-designed (and not very diverse) options. Given the need to explore all possible options in light of recent market actions, we urge Staff and the Investment Committee to conduct this study in as open a framework as possible.

If you have any questions or comments, please let me know.

Sincerely,

